Testimony Committee on Banking and Financial Services

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My name is Anne Krueger, and I am a Professor of Economics at Stanford University. My field is international economics, and I have written extensively on issues pertaining to the international financial institutions and problems associated with financial crises.

I would like to address three issues related to the ongoing efforts to improve the "architecture" of the international financial system. First, understanding of the causes of the crisis is a prerequisite for policy prescriptions to improve performance, so I shall start there. Second, I shall briefly provide my analysis of the structural reform programs put in place at the time of the crisis, and comment on the appropriate division of labor between the international financial institutions with regard to crisis management. Third, I will consider ways in which the functioning of the system might be improved.

Turning first to the causes of the crises, I think it is safe to say that there are a number of characteristics in common in Mexico in 1994, and Thailand, Malaysia, Indonesia and South Korea in 1997. The same combination of policies prevailed in Brazil prior to this January (and Brazil still has an unsustainable fiscal position). These common characteristics, or policies, were: 1) maintenance of an exchange rate policy which was determined by central bank policies and intervention, rather than the market, with a consequent tendency to real exchange rate overvaluation; 2) rapid expansion, indeed an explosion, of domestic credit, during the mid-1990's;

3) current account deficits of significant proportions (8 percent in the case of Thailand in 1997, in Mexico in 1994 and Malaysia in 1996 prior to a reduction to 5 percent in 1997, and 3 and 5 percent respectively in Indonesia and Korea); 4). a relatively open capital account, so that expansion of domestic credit was equivalent to increasing the contingent liabilities of the government; and 5) diminishing levels of international reserves as it was recognized that this policy combination was unsustainable.

The precise combination of policies and triggering events differed among the countries. Mexico's currency had appreciated significantly in real terms since 1987, and the expansion of domestic credit was dramatic. Capital inflows were generated both by attractive returns resulting from NAFTA entry and by the real exchange rate appreciation. The political events of 1994 clearly triggered capital outflows, but it was nonetheless that Mexico's policy combination as of late 1994 was unsustainable. Thailand and Malaysia too had large domestic credit expansions and capital inflows under similar exchange rate policies. In these countries, as well as in Korea and Indonesia, those watching fiscal policy were fooled: instead of financing expenditures through deficit financing in the public sector, they were financed through expansion of domestic credit, which has the same effects under the exchange rate policies that prevailed. As reserves diminished, domestic residents and foreigners scurried to try to get out of the currencies before they depreciated.

In part, the magnitudes of the crises were determined by the extent of underlying policy misalignment. It is arguable that, had adjustments been made earlier, the extent of the needed correction would have been smaller. But there is also little doubt that the fact that one country has a crisis leads market participants to scrutinize their portfolios carefully. After the Mexican crisis, a number of other countries experienced sizable capital outflows; likewise, it is widely accepted that the timing of the Malaysian and Indonesian crises was affected by the earlier events in Thailand. Once burned in Thailand, foreign creditors were skittish about other investments.

That said, it should be recognized that many countries did not experience crises. Chile, for example, maintained her policy stance intact (although the depressed price of copper and the recession in some of her Latin American trading partners has certainly lowered growth prospects). Likewise, Taiwan grew at 5 percent last year despite the recession in some of her major trading partners. One could mention others. But even some countries that have not experienced "crisis" are under severe pressure because of events. Argentina, for example, is confronted by pressures emanating out of the Brazilian crisis.

Turning now to the structural adjustment programs that were adopted, it should first of all be remembered that there was very little time to act: whereas in Mexico in 1984 a Fund program was put in place in December, after the problem had first been announced in August. By contrast, there were days and not weeks in which to respond to the recent crises. Second, the crises were not "caused" by capital flows (although their timing may have been) but by underlying unsustainable policy stances. Third, once capital accounts are open and domestic credit is expanding, it is not possible to "fix" the problems resulting in crisis without addressing the banking situation.

It is probably impossible to have a rate of credit expansion that was happening in the "crisis" countries and to have adequate quality surveillance of that credit. And, in many situations, there were not even a sufficiently large number of qualified people to evaluate loan prospects. The result was that, when crises struck, there was already a significant volume of nonperforming loans on the banking systems' books. But the crisis itself generated more because domestic borrowers, attracted by apparently low foreign interest rates (implicitly underwritten by governments' exchange rate policies), found their indebtedness to banks significantly increased when the crises began.

Once there is a lot of bad paper in banks' portfolios, a foreign exchange crisis (of the kind often witnessed in developing countries in the 1960s and 1970s) cannot be resolved without addressing the key issues in the domestic banking system. Two things must be done: first, the bad paper must be removed from the banks' portfolios to enable them to resume lending; and second, means must be found to prevent a repetition of the unwarranted lending.

That the first is essential is amply demonstrated by the difficulties of the Japanese economy since the late 1980s, as there has been a "credit crunch" and a failure to generate economic expansion despite incredibly low interest rates. There is a difficult political problem in allocating the costs of the nonperforming loans among taxpayers and financial institutions' shareholders but it is highly unlikely that economic growth can resume until that problem is tackled. Often, addressing the nonperforming loan problem requires restructuring of the debt-equity composition of the capital of private companies. In the case of Korea, for example, some of the chaebol had debt-equity ratios of as much as 12:1. In such a circumstance the banks cannot be restructured until the heavily indebted enterprises swap some of the debt for equity, again a difficult economic and political problem. It should be noted, too, that these two problems must be resolved in ways that do not permit solvent borrowers to fail to service their debt.

But, it is evident that failure to address the problems in the banking system that led to overly exuberant and imprudent lending will recur unless measures are taken to restructure the financial system. Here, much less is known about how to proceed and the issues involved are intensely domestic. But some things are clear. First, unless banks have adequate capital and the incentives of owners and managers are aligned, there can be strong incentives for bank managers and/or owners to undertake unduly risky ventures: if they do not succeed, little is lost; if they succeed, the return can be high. Hence, raising capital adequacy standards can help, but cannot be done overnight. This is because, especially at a time of crisis, there are not large pools of capital available and seeking investments. Foreign banks can play a role, of course, but that is only part of the answer.

Partly because capital adequacy issues cannot be addressed as rapidly as would be desirable, but partly because of the systemic importance of the banking system – especially in middle-income countries where other sources of finance for new investment are less well developed than in industrial countries - strengthening prudential supervision of the banks is also a necessary step for recovery from crisis. This, too, is difficult. In a well-functioning economy, bankers have a comparative advantage in evaluating alternative investments and thus play a role in enabling efficient allocation of new investment funds, a task vital to healthy economic growth. But precisely because it is the local knowledge of bankers pertaining both to industry conditions and the qualities of individual borrowers, establishing a cadre of banking supervisors is also a challenging task and cannot be completed overnight.

There are two essential tasks that are necessary for managing crises and setting the stage for sustainable recovery. The first is the removal of nonperforming loans from banks' portfolios consistent with providing adequate incentives for repayment of loans by solvent debtors. The second is to insure that the buildup of nonperforming loans not be repeated. This entails recapitalization of the banks and debt-equity restructuring, both difficult challenges.

Thus, insofar as the structural adjustment programs focused on issues previously regarded as "domestic" in the financial sector, it is my judgment that measures relating to the restructuring of the banks were essential. No one in the international community, I think it is safe to say, recognized ahead of time how important the links between exchange rates, domestic credit, and an appropriate framework for financial institutions were. All were caught off guard by the magnitude of the crisis. Indeed, there is still much research to be done and much to be learned about policies affecting financial sector performance. But certainly at the time of the 1997 crises, neither the IMF nor the World Bank had the necessary expertise to bring to bear on these problems which are, as I said, in any event intensely domestic in nature.

Research analyzing alternative means of achieving financial restructuring and prudential supervision, based on the experiences of the past several years, will be highly productive in enabling domestic and international policy makers both to avoid future crises and to respond even more adroitly than they did in recent years. Certainly we can do better.

That much said, given the time and other pressures, my judgment is that overall the international financial institutions, and especially the International Monetary Fund, did well in working out the structural adjustment programs with policy makers in the afflicted countries. They imposed some conditions on domestic policy performance that were not related to the crisis, and in that sense they can be second-guessed. But overall, the situation would have been much worse without them, and especially without the IMF. The proof of that proposition is the recovery currently underway in Korea and Thailand. Even Indonesia seems to have turned the corner. All three of these economies (and Brazil currently) are recovering more rapidly than most forecasters and analysts anticipated.

That brings me to the third question: what are the ways in which the "architecture" of the international financial system can be altered to improve future performance, both by preventing crises and by setting in place structural adjustment programs conducive to rapid recovery?

For crisis prevention, there are several lessons. First, it seems to me that the evidence strongly supports the view that exchange rate policy must either be one of a fairly clean float or, in a few instances, of a currency board. A fairly clean float prevents the build-up of pressures as happened under the more fixed-rate regimes that the crisis countries had, while a currency board guarantees that the exchange rate will remain unchanged and thus prevents speculative attacks. However, a currency board is exceptionally difficult to put in place and it requires considerable political support (such as was present in Argentina given its earlier history of high inflation) <u>and</u> consistent monetary, interest rate, and fiscal policies if a currency board is to succeed. For most countries, I conclude that a fairly clean float is the only feasible solution. Policies in the middle, attempting to maintain an exchange rate regime in the middle, are very likely to run into trouble over time.

Second, improvements in financial supervision and strengthened domestic banking systems will result in greater transparency for international and domestic investors, making the benefits from ill-advised policies fewer and the costs higher than they have been in the past. Third, many developing countries may find it desirable to hold higher levels of reserves than they have been doing, although if the underlying policy stance is inconsistent, high reserves can simply hold of an attack for a while, making it more severe when it does finally eventuate. Fourth and most important, attainment of consistent domestic macroeconomic policies (including measures that prevent overly rapid expansion of domestic credit) will do much to prevent crises.

It is perhaps the first and fourth points that provide most basis for optimism. Policy makers around the world have witnessed the appalling costs of financial and exchange rate crises. The lesson that fixed nominal exchange rates are crisis-prone seems to be being learned. If, in addition, policy makers address their underlying macroeconomic policy stance, the changes of future crises will be greatly reduced.

An alternative policy measure that has been proposed is that there should be stronger controls on capital flows than there were in the crisis countries, based on the reasoning that capital controls would have prevented the capital inflows that reversed during the crises. In my judgment, this argument is flawed on several grounds, although I would agree that countries with relatively closed capital accounts should open them up as they achieve other conditions for macroeconomic stability and growth. But if there had been controls on capital flows, it is likely that they either would have been ineffective or they would have resulted in a delay (but not an avoidance) of crisis. As long as nominal exchange rates were more or less fixed, there were above-average rates of return to be achieved by inward flows of capital by foreigners and there were equally strong temptations for domestic residents to find means of obtaining funding from abroad. These decisions were profitable until the crisis struck. In my judgment, proposals for capital controls seek to avoid the necessity for consistency in macroeconomic policies which is the only way in the longer run that crises can be avoided.

I turn, then, finally to the question of how the architecture of the international financial system can be improved. In general, I concur with those who believe that a number of relatively small and unglamorous changes, rather than a major overhaul, is what is called for. Clearly, we need to learn more about prudential supervision of banking systems, and otherwise improve the transparency of the system. Whether it should be the IMF, the World Bank, or the BIS that should undertake this work is, it seems to me, relatively unimportant. Indeed, at this stage of our knowledge, having several agencies try several different approaches, with competition among them, may be the fastest way to learn.

But those measures will take time and will never be perfect. Another measure that has considerable appeal would be one that more appropriately reflected the risks of foreign lending to creditors. In part because there are so many lenders, and loans have cross-default conditions, the international financial institutions are confronted with a degree of urgency in addressing financial crises that is beyond the capacity of any institution to handle. And the financial strength of the international financial institutions is small relative both to private capital markets and to the volume of outstanding credit. One intriguing market-based proposal centers on this apparent flaw. Under this proposal, borrowers (or governments of countries of the borrowers) might seek (or require) clauses in loan contracts which would permit borrowers to unilaterally suspend debt service for a specified period or periods, possibly at a penalty interest rate to be accrued during the suspension period..

Having such clauses in loan contracts would have a number of desirable effects. Countries where the risk of suspension was higher would be confronted with higher interest rates than countries with low risks. Lenders would need to examine the risk of suspension carefully. The interest rate premium on lending to high-risk countries would deter borrowing in those countries (or simply more accurately reflect the cost of borrowing). The clauses represent a market-based solution. And the relative costs of different forms of capital inflow (direct foreign investment, equity acquisition, bonds, and bank lending) would be more appropriately reflects to borrowers.

Currently, there are a number of these proposals on the table, and they seem to have fewer flaws than most others. One can even imagine ways in which such clauses might be invoked only with IMF involvement, or indeed, in such a way that the IMF was the one that called for suspension. The IMF might also develop rules for support of countries in financial crisis. If these rules specified that there could be no assistance unless exchange rates were floating and loan contracts had such clauses, it would enable far better coordination among private creditors than has been possible in the past. I do not believe that there is any concrete proposal yet sufficiently well worked out and thought through to be implementable at the present time But I do believe that analysts in the policy community are progressing in the formulation of the concerns and ways to achieve a better balance between risks across classes of assets

Hopefully, measures such as these can be thought out and implemented. At the same time, the longer term agenda to find means for strengthening financial institutions in individual countries must be pursued. It is doubtful if anything will prevent ALL financial crises in the future: there are too many new governments incapable of formulating consistent macroeconomic policies, and there are too many shifts in domestic and international economic conditions, to avoid any recurrency. But learning the lessons regarding exchange rates and the importance of macroeconomic consistency will help. So, too, will be measures increasing transparency. If means can be found to shift the costs of crisis somewhat more toward creditors in the case of bank lending, that, too, will help.

The history of the now-industrialized countries is full of financial crises. As developing countries successfully achieve growth, they too have to strengthen their financial systems. Improving the international financial architecture along the lines I have discussed will improve growth prospects for those countries and, hence, for the world as a whole.

I will be happy to address any questions you may have.